NEW DOL REGULATIONS ON INDEPENDENT CONTRACTOR STATUS: WHAT EMPLOYERS NEED TO KNOW

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On January 10, 2024, the U.S. Department of Labor (DOL) issued new regulations governing how to determine whether a worker is an employee for Fair Labor Standards Act overtime purposes or whether they qualify as an independent contractor (sometimes called a "contract employee"). The independent contractor rules became effective on March 11, 2024. These new rules replace the independent contractor rules DOL issued in 2021.

The 2024 rules return to using the "economic reality test" that DOL and the courts have relied on since the 1940s. This test focuses on whether a worker is economically dependent on an employer or is truly in business for themselves.

To learn more about the new regulations and avoid potential penalties, read on.

BACKGROUND

The federal Fair Labor Standards Act (FLSA) sets the requirements for determining who qualifies as an employee exempt from overtime pay and who is nonexempt and entitled to overtime pay. For earlier blog posts on how to determine who is exempt and who is nonexempt, see here (https://canons.sog.unc.edu/2013/10/salaried-employees-and-the-flsa/), here (https://canons.sog.unc.edu/2013/12/the-flsas-executive-exemption-from-overtime-pay/), here (https://canons.sog.unc.edu/2014/02/the-flsas-administrative-exemption-from-overtime-pay/), here (https://canons.sog.unc.edu/2014/08/the-flsas-professional-duties-test-part-1/), and here (https://canons.sog.unc.edu/2014/09/the-flsas-profession-exemption-part-2-the-computer-professional/). The FLSA's overtime and minimum wage requirements only apply to employees, not to independent contractors. This makes engaging someone as an independent contractor, rather than hiring them as an employee, seem attractive, as

does the fact that employers do not owe payroll taxes on independent contractors, do not have to provide them with benefits and do not cover them under their workers compensation policies.

Employers often assume that a mutual agreement designating a worker as an independent contractor automatically removes them from employee status. That is not the case. “Independent contractor” is a distinct legal status determined by factors that go beyond the employer and employee’s mutual desire to contract for work on this basis.

In fact, worker status is evaluated differently depending on the law in question. The Internal Revenue Service (IRS), anti-discrimination laws, and state unemployment benefit rules all have their own tests for determining if someone is an employee or independent contractor. While these tests are similar, the specific factors can vary. This blog post focuses specifically on the new DOL regulations under the FLSA. To learn more about the IRS test and the common law rules for determining employee or independent contractor status, see here (https://www.sog.unc.edu/sites/default/files/reports/pelb32.pdf), pp. 4 – 20.

The key point is that simply labeling a worker as an independent contractor isn’t enough. Employers need to carefully evaluate each situation based on the DOL’s economic reality factors to ensure workers are properly classified. Getting this wrong can be costly.

THE NEW FLSA REGULATIONS ON INDEPENDENT CONTRACTOR STATUS

The text of the FLSA itself doesn’t define “independent contractor.” It does, however, define (https://www.law.cornell.edu/uscode/text/29/203)the term “employee” in very broad language. An “employee” is simply “any individual employed by an employer.” And an “employer” is “any person acting directly or indirectly in the interest of an

employer in relation to an employee," while to "employ" someone is "to suffer or permit [them] to work." It is hard to see what sort of worker does **not** fall within the FLSA's definition of employee – it seems to cover everybody.

DOL and the courts nevertheless recognize that there are people who perform work who simply cannot be called employees of an organization. To determine whether a worker is an employee for FLSA purposes, the courts developed and refined over many years an "economic reality test."

The Economic Reality Test

The core of the economic reality test is determining whether a worker is economically dependent upon the organization for which he or she renders services, or if the worker is truly operating their own independent business. In other words, the key question is: does the worker depend upon an "employer" for the opportunity to do their work or is the worker running their own business? Prior to the brief 2021 rules, the economic reality test traditionally looked at six specific factors to make this determination. The new 2024 DOL regulations have brought back this familiar six-factor analysis.

The new regulations may be found in a new Part 795 to Chapter 29 of the Code of Federal Regulations (CFR) (https://www.ecfr.gov/current/title-29/subtitle-B/chapter-V/subchapter-B/part-795).

The Economic Reality Test's Six Factors

At 29 CFR § 795.110 (https://casetext.com/regulation/code-of-federal-regulations/title-29-labor/subtitle-b-regulations-relating-to-labor/chapter-v-wage-and-hour-division-department-of-labor/subchapter-b-statements-of-general-policy-or-interpretation-not-directly-related-to-regulations/part-795-employee-or-independent-contractor-classification-under-the-fair-labor-standards-act/section-795110-economic-reality-test-to-determine-economic-dependence), DOL says that the economic reality test's six factors are meant to be "tools or guides." More importantly, no single factor is dispositive in determining worker status and, indeed, some of them overlap. Each situation is evaluated considering all of the circumstances of a particular employer-worker relationship. Depending on the situation, one factor may weigh more heavily in the determination than another. The six factors are also not exclusive; additional factors

may be considered. This approach is consistent with the framing of the economic reality test by the courts. See, for example, *Chao v. Mid-Atlantic Installation Services, Inc.*, 16 Fed. Appx. 104, 106, 2001 WL 739243 **1 (4th Cir. 2001).

Factor #1: Opportunity for Profit or Loss Based on Managerial Skill

This factor looks at whether the worker has an opportunity to make a profit or a loss through their work. The ability to make a profit or sustain a loss on a job is the hallmark of being an independent contractor, rather than an employee. However, the regulations clarify that this profit/loss opportunity must depend on the worker's own business skills and initiative. Simply having the ability to work more hours or take on additional jobs doesn't automatically indicate independent contractor status. Employees sometimes need to work multiple jobs just to make ends meet – that doesn't mean they are running their own business. The opportunity to make a profit or loss has to stem from the worker's own managerial decisions and entrepreneurial judgment. The types of actions that can impact a worker's ultimate earnings and that point to independent contractor status under this factor include negotiating one's own pay rate, choosing which projects to accept, and investing in one's own equipment or staff. In contrast, employees who are paid a flat hourly wage or salary typically don't have a profit/loss possibility based on their own business decisions. Their earnings are fixed and dependent on the employer's decisions.

The following questions are relevant to a profit or loss inquiry:

- Can the worker negotiate the charge or the pay for the work in a meaningful way?
- Does the worker accept or decline jobs?
- Do they choose the order in which individual jobs are done or time when individual jobs are performed?
- Does the worker use marketing or advertising tools or make other efforts to expand their business or get more work?
- Does the worker make decisions about hiring additional workers or purchasing materials and equipment or renting space to get the work done?

This factor may be found at 29 CFR § 795.110(b)(1) (https://casetext.com/regulation/code-of-federal-regulations/title-29-labor/subtitle-b-regulations-relating-to-labor/chapter-v-wage-and-hour-division-department-of-labor/subchapter-b-statements-of-general-policy-or-interpretation-not-directly-related-

to-regulations/part-795-employee-or-independent-contractor-classification-under-the-fair-labor-standards-act/section-795110-economic-reality-test-to-determine-economic-dependence).

Factor #2: Investments by the Worker vs. the Employer

This factor is closely tied to the first one looking at the worker's opportunity for profit or loss. The investments the worker has made in their work can be a key indicator of whether they are truly operating an independent business.

This is a potentially tricky factor to assess. The regulations emphasize that a worker's investments must be "capital or entrepreneurial" in nature. Investing in things like supplies and equipment or hiring assistants shows that a worker has put their own money and business efforts into supporting their work. A worker who hasn't made any meaningful investments like this likely doesn't have the same potential for profit or loss as a true independent contractor would. The key is that the worker's investments must be the type that support an independent business – things that increase their capabilities, reduce their costs, or expand their reach in the market. Where the employer is supplying materials, equipment and personnel, it is evidence of an employment relationship.

Just as important is comparing the worker's investments to what the employer is providing. The worker doesn't necessarily need to have invested more money than the employer has. The focus should be on the types of investments each party has made. Where the worker is making the same types of investments as the employer (even if on a smaller scale), this would indicate that the worker is operating independently and weighs in favor of independent contractor status. In contrast, if the employer is supplying all the core materials, equipment, and personnel, that's a stronger sign of an employment relationship rather than an independent business.

This factor is found at 29 CFR § 795.110(b)(2) (https://casetext.com/regulation/code-of-federal-regulations/title-29-labor/subtitle-b-regulations-relating-to-labor/chapter-v-wage-and-hour-division-department-of-labor/subchapter-b-statements-of-general-

policy-or-interpretation-not-directly-related-to-regulations/part-795-employee-or-independent-contractor-classification-under-the-fair-labor-standards-act/section-795110-economic-reality-test-to-determine-economic-dependence).

Factor #3: How Permanent Is the Work Relationship?

This factor focuses on the expected duration of the working relationship. Where an employer engages a worker indefinitely, or where the worker has performed services for the hiring organization for an extended period of time, the worker is more likely to be an employee. Independent contractor relationships are usually more short-term or project-based, as the worker is running their own independent business and marketing their services to multiple clients. They have the freedom to work for other organizations during gaps between projects.

The regulation recognizes that an independent contractor may have recurring work with the same employer. Nevertheless, seasonal or temporary work does not automatically confer independent contractor status on a worker, especially where there are operational characteristics that make the work temporary. Take, for example, a city or county that hires the same lifeguard to work at its outdoor pool every summer. The lifeguard is likely still an employee, even though the relationship is not a permanent, year-round one. The seasonal, recurring nature of the work doesn't provide the same independent business opportunities as a true independent contractor relationship.

The key is evaluating whether the work engagement has the hallmarks of a lasting employment arrangement, or if it is more project-based and allows the worker to market their services to multiple clients.

This factor is found at 29 CFR § 795.110(b)(3) (https://casetext.com/regulation/code-of-federal-regulations/title-29-labor/subtitle-b-regulations-relating-to-labor/chapter-v-wage-and-hour-division-department-of-labor/subchapter-b-statements-of-general-

policy-or-interpretation-not-directly-related-to-regulations/part-795-employee-or-independent-contractor-classification-under-the-fair-labor-standards-act/section-795110-economic-reality-test-to-determine-economic-dependence).

Factor #4: How Much Control Does the Employer Have?

This factor examines the level of control the employer has over both the worker's day-to-day duties as well as over the economic aspects of their working relationship. The more control the employer has over a worker, the more likely it is that the worker should be classified as an employee rather than an independent contractor. Some important questions to consider are:

- whether the employer sets the worker's schedule and hours;
- whether the employer has the right to change the worker's job duties or reassign duties as needed;
- whether the employer explicitly limits the worker's ability to work for others (for example, by requiring a worker to obtain permission for a second job);
- whether the employer directly monitors the worker or the progress of the work through electronic means (by requiring the worker to enter start and stop times, for example, or through the use of video cameras or GPS trackers);
- whether it is the employer or the worker who controls the price or rates for the services the worker performs;
- whether the employer controls any marketing or advertising related to the worker's services; and
- whether the employer supervises the performance of the work.

An employer's close supervision and management of the worker and their work activities points more towards an employment relationship. The regulations recognize that sometimes an employer may have the right to exert control over a worker's performance, even if they choose not to exercise that control closely on a day-to-day basis. Reserving that oversight ability, even without exercising it, can indicate an employer-employee relationship.

This factor is found at 29 CFR § 795.110(b)(4) (https://casetext.com/regulation/code-of-federal-regulations/title-29-labor/subtitle-b-regulations-relating-to-labor/chapter-v-wage-and-hour-division-department-of-labor/subchapter-b-statements-of-general-policy-or-interpretation-not-directly-related-to-regulations/part-795-employee-or-independent-contractor-classification-under-the-fair-labor-standards-act/section-795110-economic-reality-test-to-determine-economic-dependence).

Factor #5: How Central is the Worker's Role?

The focus of this part of the economic reality test is whether the function or service the employee performs is a core, essential part of the employer's primary mission and objectives. If the worker is carrying out critical functions that are deeply integrated into

the employer's primary purposes and activities, that points towards an employment relationship rather than independent contractor status. In the context of government, the question will frequently be whether the worker is providing a core government service. For example, county health department nurses providing childhood vaccinations would be an integral part of the county's public health mission. The same could be said for building inspectors enforcing codes for a city's inspections department.

Another way to evaluate this factor is to ask whether the worker performs the same or similar work as others who are classified as employees. When "independent contractors" perform the same work as employees, they are considered integrated into the employer's hierarchy and are more likely to be deemed by courts to be employees. Where the services the worker provides are not necessary or central to the employing organization's mission or purpose, this factor will weigh in favor of independent contractor status.

The key is whether the work is necessary and fundamental to the employer's operations, or more supplemental in nature. This factor is found at 29 CFR § 795.110(b)(5) (https://casetext.com/regulation/code-of-federal-regulations/title-29-labor/subtitle-b-regulations-relating-to-labor/chapter-v-wage-and-hour-division-department-of-labor/subchapter-b-statements-of-general-policy-or-interpretation-not-directly-related-to-regulations/part-795-employee-or-independent-contractor-classification-under-the-fair-labor-standards-act/section-795110-economic-reality-test-to-determine-economic-dependence).

Factor #6: Skilled Work and Independent Initiative

This factor considers two key elements — whether the worker uses specialized skills in the service of the employer, and whether the worker uses business-minded initiative to seek out new assignments and clients. Having specialized skills alone is not enough to indicate independent contractor status. Many employees also utilize specialized skills as part of their job duties for an employer. Does the worker instead market their special skills and services through their own advertising or networking efforts? What counts is whether the worker exercises significant initiative in locating and accepting work opportunities or clients based on their own criteria, rather than simply taking assigned work from the employer. These types of entrepreneurial habits and independent business initiatives point towards classification as an independent contractor. In contrast, if the worker is simply providing skilled labor under the employer's directives and constraints, that leans more towards an employment relationship. This factor is

found at 29 CFR § 795.110(b)(6) (https://casetext.com/regulation/code-of-federal-regulations/title-29-labor/subtitle-b-regulations-relating-to-labor/chapter-v-wage-and-hour-division-department-of-labor/subchapter-b-statements-of-general-policy-or-interpretation-not-directly-related-to-regulations/part-795-employee-or-independent-contractor-classification-under-the-fair-labor-standards-act/section-795110-economic-reality-test-to-determine-economic-dependence).

Additional Factors

Consistent with DOL and the courts taking a comprehensive "totality of the circumstances" approach to independent contractor status under the FLSA, the regulations allow employers to examine any other relevant factors beyond the core six. The key is whether the additional factors provide useful insight into the fundamental question: is the worker operating their own independent business or are they dependent on the employer for work? Many organizations requested that DOL list specific additional factors that could potentially be relevant to this analysis, including factors specific to certain industries or job types. However, DOL chose not to formally identify any other set factors in the regulations.

Instead, the regulations give employers flexibility to evaluate any other circumstances that may shed light on the worker's level of autonomy and independence versus their economic reliance on the employer for work opportunities.

CONCLUSION

As the U.S. Department of Labor repeatedly emphasizes throughout the new regulations, the focus of independent contractor analysis is determining whether a worker is economically dependent on an employer (in which case the worker is an employee) or whether that worker is in business for themselves. The six factors set forth in the regulations are intended to provide a comprehensive framework for making this determination by evaluating the totality of the circumstances. No one factor determines independent contractor status. Every situation must be considered individually in light of all the relevant circumstances.

There is no penalty when an employer treats a worker who could be classified as an independent contractor as an employee. The cost of error is high, however, when an employer improperly treats a worker as an independent contractor when that worker

does not meet the criteria set forth in the new regulations. If the worker should have been classified as a nonexempt ***employee***, the employer may be liable for up to two to three years of back overtime pay, plus an equivalent amount in liquidated damages.

Misclassification also creates issues from a tax standpoint. A worker misclassified as an independent contractor for FLSA purposes will likely also fail the test used by the IRS. This can trigger further penalties for the employer, including liability for:

- 5% of a misclassified worker's federal income tax liability,
- the full employer share of missed FICA contributions,
- up to 20% of an employee's missed FICA contributions, and
- interest and other penalties on under-withheld amounts.

All in all, the financial risks of misclassification are substantial. When in doubt, it is safer to classify a worker as an employee than an independent contractor.